

REPORT OF EXAMINATION
OF THE
VETERINARY PET INSURANCE COMPANY

AS OF
DECEMBER 31, 2004

Participating State
and Zone:

California

Filed June 1, 2006

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Los Angeles, California
May 19, 2006

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Gary L. Smith
Secretary, Zone IV-Western
Director of Insurance
Department of Insurance, State of Idaho
Boise, Idaho

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of the

VETERINARY PET INSURANCE COMPANY

(hereinafter also referred to as the Company) at the statutory home office and primary location of its books and records, 3060 Saturn Street, Brea, California 92822.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2004. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2004, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; and sales and advertising.

SUBSEQUENT EVENTS

On June 8, 2005, Scottsdale Insurance Company (SIC), the Company's upstream parent, advanced the Company \$15 million as a surplus note contribution. This note bears interest at a fixed rate of 5 percent, with semi-annual payments of interest only. Payment of interest or principal requires written approval of the Insurance Commissioner of the State of California. This certificate of contribution was approved by the California Department of Insurance (CDI). In addition, effective July 6, 2005, the CDI approved the merger of Veterinary Pet Services, Inc. with and into the Company, with the Company being the surviving entity.

COMPANY HISTORY

In December of 1997, the Company's parent, Veterinary Pet Services, Inc. (VPSI), formerly California Veterinary Services, sold a portion (approximately 40%) of its controlling interest in the Company to Veterinary Centers of America, Inc. (VCA). The sale was completed through the issuance of certain shares of Series A preferred stock together with warrants to purchase common stock.

In 2000, Scottsdale Insurance Company (SIC) purchased all the preferred shares previously owned by VCA. The Company received an additional \$4 million capital contribution from Scottsdale. This capital infusion resulted in the issuance of non-voting convertible preferred shares of VPSI to SIC. The Company is a wholly-owned subsidiary of Veterinary Pet Services, Inc. (VPSI), a California corporation.

On April 14, 2003, VPSI sold 750,000 shares of its common stock to SIC at a purchase price of \$9 million, of which \$5 million was contributed by VPSI to the statutory capital and surplus of the

Company. On April 15, 2003 VPSI sold 500,000 shares of its common stock to the IAMS Company (IAMS), a subsidiary of Procter & Gamble Company, at a purchase price of \$6 million, all of which was contributed to the statutory capital and surplus of the Company. SIC, a member of the Nationwide Insurance Group, owns approximately 61% of the outstanding common stock of VPSI and IAMS owns approximately 9% of the outstanding common stock of VPSI. The remaining 30% ownership of VPSI resides with approximately 900 individual veterinarians and employees.

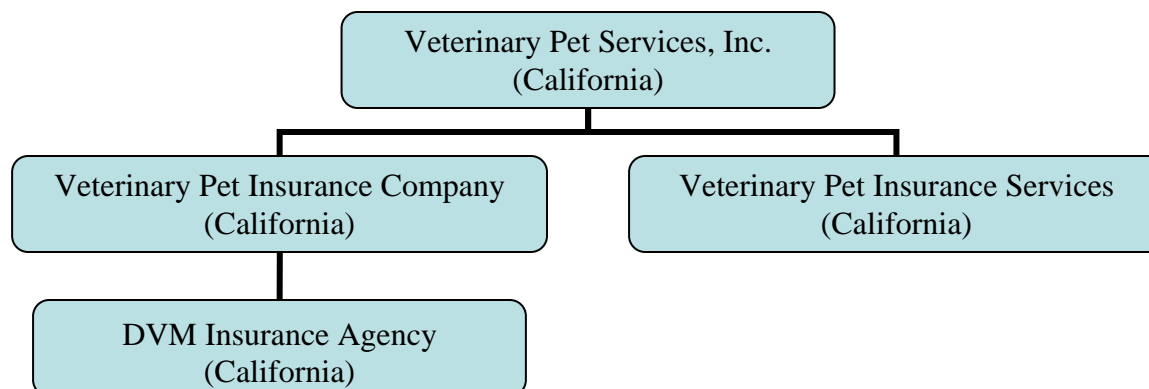
The California Department of Insurance (CDI) requires the Company to maintain a minimum statutory capital and surplus of greater than \$2 million. Effective August 6, 2003, the CDI agreed to allow the Company to operate above the National Association of Insurance Commissioners' acceptable range of net premiums written to surplus ratio of 3:1 with a ratio of no greater than 5:1 and at a minimum Risk Based Capital (RBC) ratio of 200%. In addition, it was also agreed that VPSI will increase its RBC ratio to 250% if the Company's block of business becomes unprofitable.

During 2003, the Company received \$14.5 million in capital contributions from its parent in order to keep its RBC ratio and the net premium written to policyholders surplus ratios within the agreed upon ranges.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Veterinary Pet Services, Inc. (VPSI). As of December 31, 2004, Scottsdale Insurance Company owns 61% of the outstanding common stock of VPSI and Iams Company (IAMS) owns approximately 9% of the outstanding common stock of VPSI. The remaining 30% ownership of VPSI resides with approximately 900 individual veterinarians and employees.

The following is an abbreviated organization chart depicting the relationship of the Company within the holding company system (all ownership is 100%):



Management of the Company is vested in a five-member board of directors elected annually. There were only four directors as of December 31, 2004. The Company provided a letter stating that a fifth director will be appointed by the end of 2005. The fifth member was elected in December of 2005. A listing of the members of the board and principal officers serving on December 31, 2004 follows:

Directors

Name and Residence

Principal Business Affiliation

David J. Lancer
Palm Coast, Florida
Michael D. Miller
Scottsdale, Arizona

Retired Controller, Veterinary Pet Insurance
Company
President and Chief Operating Officer
Scottsdale Insurance Company

Gary L. Tiepelman
Scottsdale, Arizona

Vice President, Scottsdale Insurance
Company

R. Max Williamson
Scottsdale, Arizona

Retired President, Scottsdale Insurance
Company

Principal Officers

<u>Name</u>	<u>Title</u>
James W. Carney*	President and Chief Executive Officer
Michael D. Miller	Principal Accounting Officer
Rebecca F. Lewis	Vice President, Sales, Marketing and Business Development
Glenda J. Burton	Secretary

* Replaced by Dennis Drent, effective August 28, 2005.

Conflict of Interest

Company directors, officers and key employees did not complete conflict of interest questionnaires for 2001 through 2004. This was also noted during the prior examination. It is again recommended that the Company have its directors, officers, and key employees complete conflict of interest questionnaires annually and report the findings to the board of directors.

Management Agreements

Agency Agreement: The Company is a party to a General Agency Agreement with its subsidiary, DVM Insurance Agency (DVM). The Company provides the underwriting, marketing, billing, collection, and administrative services for DVM in connection with DVM's placement of the Company's insurance policies with National Casualty Company (NCC) for policies outside of California. The Company receives all commissions provided to DVM by NCC in consideration for the services the Company provides. The commissions paid for 2004, 2003 and 2002 were \$20.6 million, \$16.1 million and \$14.1 million, respectively.

Tax Sharing Agreement: The Company and its affiliates are parties to a Tax Sharing Agreement dated September 30, 2002 with Veterinary Pet Services, Inc. (VPSI), its ultimate parent. VPSI prepares and files the consolidated federal income tax return and pays any amounts due. The tax liability for each subsidiary of VPSI is based on separate return calculations and such amounts are payable to VPSI. All settlements are to be made within thirty days of the filing of the applicable

estimated tax or the filing of the consolidated federal corporate income tax return with the Internal Revenue Service except where a refund is due to VPSI in which case VPSI may defer payments to its subsidiaries to within thirty days of receipt of the refund.

During the course of the examination it was noted the Company does not have an agreement for allocating costs between its affiliate, VPI Services Inc., for services provided by the Company. The Company operates a nationwide pet registry service for its policyholders that includes a pet identification and pet recovery program for lost pets through VPI Services, Inc. The prior examination report recommended that the Company establish an agreement. It is again recommended that the Company establish an agreement with its affiliate to properly allocate expenses paid on behalf of its affiliate.

CORPORATE RECORDS

The Company's minutes failed to document specific references to amounts, facts and the values of the securities as required under California Insurance Code (CIC) Section 1201 subsequent to September 19, 2003. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 1201.

TERRITORY AND PLAN OF OPERATION

The Company provides medical coverage for pets, primarily dogs and cats. Although the Company is licensed only in California, business is generated countrywide through a fronting arrangement with Nationwide Casualty Company and Scottsdale Insurance Company, subsidiaries of Nationwide Mutual Insurance Company. As of January 1, 2003, Veterinary Pet Services, Inc. (VPSI) sold its subsidiary DVM Insurance Agency, Inc. (DVM) to the Company for \$1,000. DVM acts as the Company's nonresident agent for policies written outside of California.

In 2004, the Company wrote \$22.6 million of direct premiums. The Company assumed \$56 million in premiums from Scottsdale Insurance Company which were produced by DVM. Net written premiums were \$78.7 million in 2004.

LOSS EXPERIENCE

The Company reported operating and net losses in a majority of the years under examination as follows:

Year	Net Operating Gain or (Loss)	Net Income Or (Loss)
2001*	\$ (567,668)	\$ 530,680
2002*	(393,282)	1,047,267
2003*	(4,599,166)	(2,217,653)
2004*	(7,550,253)	(2,613,987)

*The above figures are based on the Company's restated amounts

The Company has experienced poor operating results due to its above average expense structure. The Company has maintained its reported surplus position since the previous examination primarily through capital contributions, including a \$14.5 million capital infusion in 2003.

REINSURANCE

Assumed

DVM Insurance Agency (DVM), a licensed, non-resident insurance agency places all insurance written outside California with National Casualty Company (NCC). NCC, in turn, reinsures 100% of this business with Scottsdale Insurance Company (SIC). The Company assumes this business through a reinsurance agreement with SIC on an 80% quota-share basis. The reinsured receives a flat ceding commission of 33.5% based on the net written premium ceded.

The Company provides the underwriting management, administrative, marketing, sales, customer service, accounting, data processing, and claims settlement services for DVM in connection with DVM's placement of the Company's insurance policies with NCC for policies outside of California. NCC pays DVM a 28.5% commission. The Company receives 100% of the net commissions provided to DVM by NCC in consideration for the services the Company provides. The commissions paid for 2004 were \$20.6 million.

SIC considers the Company an unauthorized reinsurance company, as it is not licensed to write directly in any states other than California. As a result, the Company obtained a letter of credit in the amount of \$14 million to secure the reinsurance credits claimed by SIC.

Ceded

The Company does not participate in any ceded reinsurance agreements.

ACCOUNTS AND RECORDS

Escheat Procedures

The Company does not have any written procedures for escheatable funds and does not file reports as required by the California Unclaimed Property Act. It is recommended that the Company establish written procedures and file the necessary reports as required by the California Unclaimed Property Act.

Information System Controls

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of the review, weaknesses were noted in areas such as accuracy of processed data, audit trails, and contingency planning. The weaknesses noted were presented to the Company along with recommendations to strengthen its controls. The Company is currently making efforts to strengthen its information system controls. It is recommended that the Company continue to review its information systems and make appropriate changes to strengthen internal controls.

Financial Reporting Accuracy

In connection with the implementation of a new software system in November 2001, the Company discovered incompatibilities in 2003 between the financial reports generated by the new software

system and the Company's internal reports. The Company hired several consultants and worked with the software developer to correct the problems. As a result, the Company was unable to file the December 31, 2004 Annual Statement until December 2005. In addition, the Company restated the financial information for 2000, 2001 and 2002. The Company also filed an amended and restated Annual Statement 2003.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Underwriting and Investment Exhibit for the Year Ended December 31, 2004

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2004

Statement of Financial Condition
as of December 31, 2004

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 30,451,094	\$	\$ 30,451,094	
Stocks:				
Preferred stocks	665,800		665,800	
Common stocks	1,000	1,000	0	
Cash and short-term investments	7,114,524		7,114,524	(1)
Investment income due and accrued	305,679		305,679	
Agents' balances or uncollected premiums:				
Deferred premiums, agents' balances and installments booked but deferred and not yet due	24,082,672	948,931	23,133,741	
Current federal and foreign income tax recoverable and interest thereon	1,278,945		1,278,945	
Net deferred tax asset	6,755,062	6,755,062		
Electronic data processing equipment and software	3,070,187	3,070,187	0	
Furniture and equipment, including health care delivery assets	1,294,462	1,294,462		
Receivables from parent, subsidiaries and affiliates	5,247,884	1,293,149	3,954,735	
Aggregate write-ins for other than invested assets	<u>1,152,266</u>	<u>418,276</u>	<u>733,990</u>	
Total assets	<u>\$ 81,419,575</u>	<u>\$ 13,781,067</u>	<u>\$ 67,638,508</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 5,282,000	(2)
Loss adjustment expenses			469,858	(2)
Commissions payable, contingent commissions and other similar charges			359,140	
Other expenses			5,985,245	
Taxes, licenses and fees			126,373	
Unearned premiums			42,043,544	
Advance premiums			477,614	
Payable to parent, subsidiaries and affiliates			2,716,887	
Aggregate write-ins for liabilities			<u>2,231,092</u>	
Total liabilities			59,691,753	
Common capital stock		\$ 1,000,000		
Gross paid-in and contributed surplus		22,724,557		
Unassigned funds (surplus)		<u>(15,777,802)</u>		
Surplus as regards policyholders			<u>7,946,755</u>	
Total liabilities, surplus and other funds			<u>\$ 67,638,508</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2004

Statement of Income

Underwriting Income

Premiums earned		\$ 74,992,947
Deductions:		
Losses incurred	\$ 41,151,269	
Loss expense incurred	3,246,215	
Other underwriting expenses incurred	<u>38,145,716</u>	
Total underwriting deductions		<u>82,543,200</u>
Net underwriting loss		(7,550,253)

Investment Income

Net investment income earned	\$ 1,118,808	
Net realized capital losses	<u>(40,281)</u>	
Net investment gain		1,078,527

Other Income

Finance and service charges not included in premiums	\$ <u>3,857,739</u>	
Total other income		<u>3,857,739</u>
Net loss		<u>\$ (2,613,987)</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2003		\$ 11,582,722
Net loss	\$ (2,613,987)	
Net unrealized capital losses	(5,514)	
Change in net deferred income tax	151,530	
Change in nonadmitted assets	661,328	
Aggregate write-ins for losses in surplus	<u>(1,829,324)</u>	
Change in surplus as regards policyholders		<u>(3,635,967)</u>
Surplus as regards policyholders, December 31, 2004		<u>\$ 7,946,755</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2004

Surplus as regards policyholders, December 31, 2001, per Examination			\$ 3,864,600
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net loss	\$	\$ 3,784,374	
Net unrealized capital gains	5,948		
Change in net deferred income tax	3,137,474		
Change in nonadmitted assets		6,754,869	
Capital changes: Paid-in	14,500,000		
Aggregate write-ins for losses in surplus	<u> </u>	<u>3,022,024</u>	
Totals	<u>\$ 17,643,422</u>	<u>\$ 13,561,267</u>	
Net increase in surplus as regards policyholders for the examination period			<u>4,082,155</u>
Surplus as regards policyholders, December 31, 2004, per Examination			<u>\$ 7,946,755</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Short-term Investments

During the course of the examination it was determined that UBS Financial Services acted as a custodian for the Company's short-term investments. UBS Financial Services is a registered broker/dealer and is not a qualified custodian as defined by California Insurance Code (CIC) Section 1104.9. It is recommended that the Company place its securities with a qualified custodian in accordance with CIC Section 1104.9.

(2) Losses and Loss Adjustment Expenses

The Company's reserves were evaluated by a Casualty Actuary from the California Department of Insurance. Based on the analysis, the Company's December 31, 2004 reserves for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination report.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Conflict of Interest (Page 5): It is again recommended that the Company provide completed conflict of interest questionnaires.

Management and Control – Management Agreements (Page 6): It again is recommended the Company establish an agreement to properly allocate expenses paid on behalf of its affiliates.

Corporate Records (Page 7): It again is recommended that the Company implement procedures in its board meetings to ensure compliance with California Insurance Code (CIC) Section 1201.

Accounts and Records – Escheat Procedures (Page 9): It is recommended that the Company establish written procedures for escheatable funds and file the required reports in accordance with the California Unclaimed Property Act.

Accounts and Records – Information System Controls (Page 9): It is recommended that the Company continue to review its information systems and make appropriate changes to strengthen internal controls.

Comments on Financial Statement Items – Short-term Investments (Page 14): It is recommended that the Company place its securities with a qualified custodian in accordance with CIC Section 1104.9.

Previous Report of Examination

Management and Control – Conflict of Interest (Page 5): It was recommended that the Company provide current completed conflict of interest questionnaire. The Company is still not in compliance with this recommendation.

Management and Control – Board of Directors Meetings (Page 5): It was recommended that the Company comply with its bylaws. The Company is in compliance.

Management and Control – Cost Allocation Agreement (Page 6): It was recommended the Company establish an agreement to properly allocate expenses paid on behalf of its parent and affiliates. The Company is still not in compliance with this recommendation.

Corporate Records (Page 6): It was recommended that the Company implement procedures to ensure future compliance with California Insurance Code (CIC) Sections 735, 1200 and 1201. The Company is still not in compliance with CIC 1201.

Accounts and Records (Page 9): It was recommended that its reinsurance premiums receivable be properly recorded. The Company is now recording its reinsurance premiums receivable properly.
Comments on Financial Statement Items – Bonds (Page 14): It was recommended that the Company file its securities with the NAIC Securities Valuation Office. The Company's securities are now considered filing exempt and are not required to be filed with the NAIC Securities Valuation Office.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Laura Clements, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California